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Ex Parte

June 14, 2000

Mr. Lawrence E. Strickling, Chief
Common Carrier Bureau
Federal Communications Commission
445 Twelfth Street, SW
Washington, D.C. 20554

Re: CALLS ILECs' *ex parte* letters in CC Docket 98-137, 99-117 and 98-26.

Dear Mr. Strickling:

The Federal Communications Commission ("FCC" or "Commission") has biennially reviewed the depreciation requirements of the incumbent local exchange carriers ("ILEC") for many years. In the 1998 depreciation represcription docket,¹ the FCC examined various proposals aimed at streamlining this regulatory process. On December 30, 1999, the Commission issued a *Memorandum Report and Order* which found, "it would be appropriate to grant a waiver of our depreciation prescription process for certain price cap incumbent LECs in certain circumstances" which the Commission deemed necessary to ameliorate any harmful impact from unrestricted changes in depreciation expenses upon consumers or competition.²

Thereafter, on March 3, 2000, the four ILEC members of the *ad hoc* Coalition for

¹ CC Docket 98-137, *In the Matter of 1998 Biennial Regulatory Review--Review of Depreciation Requirements for Incumbent Local Exchange Carriers and United States Telephone Association's Petition for Forbearance from Depreciation Regulation for Price Cap Loop Exchange Carriers*, ASD 98-91.

² The Commission set five conditions for approving such a represcription waiver: (1) that the ILEC adjust its net regulatory book costs to reflect its financial book value by a below-the-line write-off; (2) that the ILEC use the same depreciation factors and rates for regulatory and financial accounting purposes; (3) that the ILEC forego recovery of the amount written-off; (4) that the ILEC disclose its depreciation account information, forecast additions, and digital central office replacements to the FCC; and (5) that the waiver request comply with § 1.3 of the Commission's rules.

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Affordable Local and Long Distance Services (CALLS-ILECs)³ proposed that they be permitted to convert their regulatory depreciation accounts to match their financial books, using straight-line above-the-line amortization of differing depreciation reserve balances over a five-year period, with a commitment not to seek interstate price cap rate recovery of the amount so amortized.⁴

By Further Notice of Proposed Rulemaking ("FNPRM") adopted March 31, 2000, the Commission sought comment from interested parties on the CALLS-ILEC proposal. The Commission specifically asked whether booking the amortized depreciation above-the-line would have adverse impacts on interstate or intrastate consumers or competition given that the CALLS-ILECs would not seek interstate price cap recovery of this amortization.⁵ The Commission further asked if, given the estimated \$28 billion in depreciation reserve amortization proposed over five-years, the FCC should deem moot the findings of the audits of the continuing property records of the Regional Bell Operating Companies ("RBOCs") and GTE, which found that the carriers could not account for \$5 billion in central office equipment, which the auditors recommended be written off the carriers' books of account.⁶

Following the filing of formal comments and replies by various parties according to the schedule contained in the FNPRM,⁷ the CALLS-ILEC proponents have submitted a number of *ex parte* letters elaborating upon their depreciation proposal,⁸ as have various other interested parties. This letter is submitted to respond to the post-comment period filings of the CALLS-ILEC proponents, and is authorized by the permit but disclose *ex parte* presentation provision of the FNPRM.⁹

³ The CALLS-ILEC members are Bell Atlantic, Bell South, SBC Telecommunications and GTE.

⁴ See, March 3, 2000 CALLS-ILEC proposal.

⁵ FNPRM, ¶ 12.

⁶ FNPRM, ¶ 15.

⁷ Initial comments were due April 17, 2000 and replies on April 28, 2000.

⁸ See, CALLS-ILEC letters to Common carrier Bureau Chief Lawrence E. Strickling dated May 8, 2000, May 23, 2000 and June 1, 2000. In these three *ex parte* letters, the CALLS-ILEC proponents underscore their commitment not to seek interstate recovery of the depreciation proposed for amortization during the five-year transition period, urge that the FCC not limit the intrastate treatment of the same depreciation amounts, and described how various states have handled the issue of regulatory versus accounting depreciation lives. The CALLS-ILEC letters also respond to arguments presented in reply comments by MCI Communications and the Ad Hoc Telecommunications Users Committee.

⁹ FNPRM ¶ 16. See also, 47 C.F.R. §§ 1.1202, 1.1203, and 1.1206.

The New York State Attorney General ("NYAG") is an advocate on behalf of New York State's consumers, especially residential and small business customers of telecommunications and public utility services, and enforces consumer protection and anti-trust laws. Both as long distance service customers and as local service customers, individuals and businesses in New York State could be affected directly by the proposed depreciation changes. The impact of the CALLS-ILEC proposal on pricing decisions for unbundled network elements ("UNE") and digital subscriber line ("DSL") services could affect the nature and rate of competition for local telephone service in New York. Furthermore, the NYAG previously filed comments¹⁰ responding to the Commission's April 6, 1999 Notice of Inquiry in CC Docket 99-117 concerning the Accounting Safeguards Division ("ASD") audit of the NYNEX operating companies' continuing property records, which may be affected by the pending CALLS-ILEC proposal. After examining the ASD's audit of The New York Telephone Company d/b/a Bell Atlantic-New York ("BA-NY"), the New York State Public Service Commission ("NYSPSC") has recently instituted its own investigation of Bell Atlantic-New York's property record keeping and internal controls,¹¹ and the NYAG is a party in this state-level proceeding as well.

Because BA-NY's intrastate depreciation recovery rates are governed by the NYSPSC's seven-year intrastate price cap plan,¹² we will not discuss the merits of financial versus regulatory depreciation, nor address the potential impact of booking the proposed five-year amortization above-the-line upon intrastate ratemaking decisions. Instead, we will focus on the relationship between the CALLS-ILEC proposal and the pending ASD audit of the CALLS-ILECs' continuing property records.

The FCC audit of NYNEX/Bell Atlantic North (BA-NY comprises two-thirds of NYNEX/Bell Atlantic North with New England Telephone) examined certain categories of central office equipment reflected on the property records books, and made field visits to selected locations where the auditors asked company personnel to identify randomly chosen items from the account records. In a substantial number of instances, the property could not be found, and no records adequately documenting that the equipment had been purchased, much less deployed and then retired, were identified. The auditors found that "NYNEX/Bell Atlantic North has not maintained its basic property records and [continuing property records] in a manner consistent with the

¹⁰ See, June 4, 1999 NYAG comments.

¹¹ NYSPSC Case 00-C-0788 - *Proceeding on Motion of the Commission to Investigate the Accounting Practices of New York Telephone Company Concerning its Telephone Plant In Service, Order Instituting Proceeding*, issued May 5, 2000.

¹² NYSPSC Case 92-C-0665 - *Proceeding on Motion of the Commission to Investigate Performance-Based Incentive Regulatory Plans for New York Telephone Company - Track 2, Opinion and Order Concerning Performance Regulatory Plan*, effective August 16, 1995.

Commission's rules."¹³

After quantifying the retroactive and prospective impact of the undocumented property records on NYNEX/Bell Atlantic North, the auditors recommended that the FCC direct a \$758.2 million write-off from the company's central office equipment accounts, as well as a \$291 million write-off through a reversal of 1995-1995 equipment retirement entries. In addition to this monetary relief, the auditors recommended that the FCC direct prospective curative reforms, including retention of an independent firm to perform a comprehensive inventory of central office equipment to correct continuing property records account balances. Also recommended was retention of an independent auditor to review NYNEX/Bell Atlantic North's practices, procedures, and controls for maintain these records, so as to identify what changes are necessary to ensure that the records are maintained in compliance with the Commission's rules.

To terminate the property records audits in connection with adoption of the CALLS-ILEC depreciation proposal would be contrary to the public interest. Regardless of whether the FCC chooses to retain the existing regulatory depreciation prescription process, or permit the ILECs to convert to financial depreciation rules, there must be adequate procedures and controls on utilities' record keeping so as to establish what investment has been made which is eligible for depreciation in the first place. It is inappropriate to determine whether to book the resulting amortization above or below-the-line without at the same time ensuring that the depreciation accounts of the ILECs can be verified as reliable.

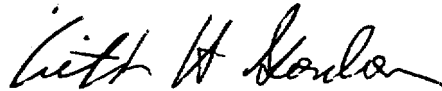
Contrary to the question raised in the FNPRM, the CALLS-ILEC depreciation proposal would not render the property audit moot. If the FCC permits the ILECs' depreciation amortization to be booked above-the-line, or below-the-line, the result will still be that these ILECs will be recovering depreciation based upon their property records. Hence, the accuracy of those investment figures upon which the depreciation reserve component of revenue requirement is based remains highly significant. Assuming *arguendo*, that the CALLS-ILEC proposal is approved in some form, after the proposed five-year amortization period of transition is completed, future regulatory determinations (using price cap or other approaches) will use the property records to compute ongoing depreciation for so long as the ILECs remain regulated.¹⁴

¹³ FCC Common Carrier Bureau Accounting Safeguards Division December 22, 1998 *Audit of the Continuing Property records of the NYNEX Telephone Operating Companies Also Known As Bell Atlantic North As of March 31, 1997*, p. 1. Similar audits of Bell South, SBC Telecommunications, Ameritech, US West and GTE reached like findings and recommendations. It should be noted that U.S. West is not a participant in the CALLS-ILEC depreciation proposal, but its property records were found to suffer similar deficiencies as GTE and the other RBOCs.

¹⁴ While there may come a time when telephone competition at both the local and interstate levels becomes so robust that the FCC and state regulatory commissions will no longer need to examine the ILECs' depreciation, the advent of this event cannot be predicted with any accuracy. Certainly, the current and foreseeable state of telecommunications markets indicates that for years after the proposed five-year amortization, the Commission will still be engaged in

Far more is at stake than the interstate write-offs recommended by the FCC's auditors. The state commissions, which rely upon the same property records for intrastate ratemaking decisions, have at stake approximately three times the interstate impact from the audit findings. As demonstrated by the recent action of the NYSPSC in opening its own inquiry into the corrective steps necessary to ensure that local service rates are not inflated by undocumented depreciation claims, the implications of the property records audit are substantial and of broad significance. For these reasons, the Commission should not link the determination of the CALLS-ILEC depreciation proposal to the pending property record audits. Regardless of how the depreciation issues are decided, the Commission should proceed to implement the audit findings and recommendations.

Sincerely,



/ Keith H. Gordon
Assistant Attorney General

Bureau of Telecommunications & Energy
New York State Attorney General's Office
Mary Ellen Burns, Bureau Chief

cc: Hon. William E. Kennard, Chairman
Hon. Susan Ness
Hon. Harold W. Furchtgott-Roth
Hon. Michael K. Powell
Hon. Gloria Tristani
Ms. Magalie Roman Salas, Secretary
Mr. Kenneth Moran, Chief, Accounting Safeguards Division

ratemaking decisions which depend upon accurate property records.